

Office of Chief Counsel
Internal Revenue Service
memorandum

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date: May 9, 2002

to: Revenue Agent [REDACTED], Team Coordinator (LMSB)

from: Associate Area Counsel (LMSB), Chicago

subject: [REDACTED] **Mutual Insurance Company**

Deductibility of Unpaid Employee Benefits as Loss Adjustment Expenses

This memorandum is in response to your request for assistance dated January 23, 2002. On March 15, 2002 we asked you for additional input, which you provided on March 27, 2002.

On May 7, 2002, we discussed this issue with industry counsel Charles W. Maurer, who provided valuable input.

This memorandum should not be cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Facts

[REDACTED] Mutual Insurance Company ("the taxpayer") is currently being examined by the Internal Revenue Service for the years [REDACTED], [REDACTED], and [REDACTED]. In each of those years, the taxpayer in its books and records allocated certain unpaid employee expenses [REDACTED]

[REDACTED] to three of the taxpayer's functions: (1) Investment Expense, (2) Loss Adjustment Expense (LAE), and (3) Other Underwriting Expense.

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The above allocation is required by the [REDACTED] Administrative Code and the amounts of the allocations made appear to be in accordance with that Code. The above allocation was reported in the taxpayer's annual statement, which was approved by the [REDACTED] Insurance Commissioner.

The taxpayer filed income tax returns for the years at issue. In accordance with I.R.C. § 404(a), the unpaid employee expenses allocated to Investment Expense and Other Underwriting Expense were not deducted in the taxpayer's returns until paid. The unpaid employee expenses allocated to LAE, however, were currently deducted in the taxpayer's returns, i.e., discounted unpaid loss adjustment expenses (as claimed on the returns) were not reduced by the discounted portion of unpaid employee benefits that were allocated to LAE.

The amounts at issue are substantial. Your proposed adjustment for this item would increase the taxpayer's taxable income by \$ [REDACTED] in [REDACTED], \$ [REDACTED] in [REDACTED], and \$ [REDACTED] in [REDACTED].

Issue

Are unpaid employee expenses that would generally not be currently deductible because of the timing requirements of I.R.C. § 404(a) currently deductible under I.R.C. § 832 when allocated to unpaid Loss Adjustment Expense, such allocation being required by the state insurance commissioner?

Law

I.R.C. § 404(a) states:

If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under this chapter; but, if they would otherwise be deductible, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year. [Emphasis added.]

I.R.C. § 404(a)(1) provides that contributions to a pension trust are (with some exceptions) deductible "in the taxable year when paid."

) I.R.C. § 404(a)(3) provides that contributions to a stock bonus or profit-sharing trust are (with some exceptions) deductible "in the taxable year when paid."

I.R.C. § 404(a)(5) provides that "any vacation pay which is treated as deferred compensation shall be deductible for the taxable year of the employer in which paid to the employee."

I.R.C. § 832(a) defines the taxable income of an insurance company as "the gross income as defined in subsection (b)(1) less the deductions allowed by subsection (c)."

I.R.C. § 832(b)(1)(A) provides that

in the case of an insurance company subject to the tax imposed by Section 831 . . . the term "gross income" means the sum of . . . the combined gross amount earned during the taxable year from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners . . .

I.R.C. § 832(b)(5)(A) defines "losses incurred" as:

Losses incurred during the taxable year on insurance contracts computed as follows:

(i) To losses paid during the taxable year, deduct salvage and reinsurance recovered during the taxable year.

(ii) To the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding the end of the taxable year and deduct all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year.

(iii) To the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverable as of the end of the taxable year.

I.R.C. § 832(b)(6) states:

The term "expenses incurred" means all expenses shown on the annual statement approved by the National Association of Insurance Commissioners, and shall be computed as follows: To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For purposes of this subchapter the term "expenses unpaid" shall not include any unpaid loss adjustment expenses [LAE] shown on the annual statement, but such unpaid losses adjustment expenses shall be included in unpaid losses. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).

I.R.C. § 832(c) contains thirteen numbered subparagraphs describing allowable deductions. The subsection states, in part:

In computing the taxable income of an insurance company . . . there shall be allowed as deductions:

- (1) all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses); . . .
- (4) losses incurred, as defined in subsection (b)(5) of this section; . . .
- (10) deductions (other than those specified in this subsection) as provided in part VI of subchapter B (section 161 and following, relating to itemized deductions for individuals and corporations) and in part I of subchapter D (section 401 and following,¹ relating to pension, profit-sharing, stock

¹ I.R.C. Sections 401 through 420.

) bonus plans, etc.); . . . [Emphasis added.]

Analysis

In our opinion, the unpaid employee benefits at issue are not deductible (even if they satisfy the requirements of I.R.C. § 832) because they do not satisfy the requirements of I.R.C. § 404.

For tax purposes, the income and deductions of insurance companies are defined by I.R.C. § 832. Under § 832(a), the taxpayer's only allowable deductions are those described in § 832(c). Section 832(c) defines thirteen deductible items, including "expenses" (§ 832(c)(1)), "losses incurred" (§ 832(c)(4)), and "deductions . . . relating to pension, profit-sharing, stock bonus plans, etc." (§ 832(c)(10)).

The taxpayer's unpaid employee benefits clearly do not satisfy § 832(c)(10). That subsection requires the benefits to satisfy the requirement of § 404 that the item be deducted in the year paid, and it is given that the benefits here were "unpaid" at the end of the years at issue.

The taxpayer did not deduct those unpaid employee compensation items which were allocated to Investment Expense or Other Underwriting Expense, and those items are therefore not at issue. It claimed a deduction, however, for that part of the unpaid employee compensation that was allocated to loss adjustment expense. Whether unpaid LAE is deductible as an "expense" under I.R.C. §§ 832(c)(1) and 832(b)(6) or as a "loss" under §§ 832(c)(4), 832(b)(5), and 832(b)(6) is an intriguing and controversial subject which, fortunately, does not concern us here. This controversy does not concern us here because I.R.C. § 404 forbids the deduction of unpaid employee compensation even if it satisfies the requirements for deductibility under § 832.

Section 404(a) states on its face that employee benefits "shall not be deductible under this chapter." "This chapter" is Subtitle A, Chapter 1 ("Normal Taxes and Surtaxes"), which begins at I.R.C. § 1 and ends at I.R.C. § 1400J. Since § 832 is included in Chapter 1, the taxpayer's deferred compensation benefits are not deductible under any part of § 832. Section 404(a) goes on to say that if the items "would otherwise be deductible" then they shall be deductible subject to the "limitations" in § 404. Even if we assume that the employee benefits allocated to LAE satisfy the deductibility requirements of § 832 (*i.e.*, "would otherwise be deductible" under § 832 as expenses or unpaid losses) they are therefore subject to the

limitations of § 404. Under the given facts, they do not satisfy the limitations of § 404 because they were not paid in the year deducted.

The taxpayer argues that it should be allowed the deduction at issue because it was included as an expense in the annual statement. The taxpayer refers to § 832(b)(1)(A), which states that "gross income" shall be "computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners" and to § 832(b)(6) which states that "the term 'expenses incurred' means all expenses shown on the annual statement approved by the National Association of Insurance Commissioners."

The extent to which the Service can challenge the computations and principles embodied in the annual statement is another controversial topic. I.R.C. § 832(a) and 832(c) are explicit, however, that a deduction must satisfy one of the thirteen subparagraphs of § 832(c) in order to be deductible for tax purposes. We believe that the fact that a deduction is allowable (or even required) on the annual statement approved by NAIC does not make it deductible on a tax return if the item does not satisfy § 832(c).

The Tax Court has stated that the requirement that the NAIC annual statement form be followed provides no support for the contention that the mere inclusion of certain figures on that statement can prevent the Commissioner from making adjustments. The taxpayer must prove his entitlement to deductions under the Internal Revenue Code. Physicians Insurance Company of Wisconsin v. Commissioner, T.C. Memo. 2001-304. See also Western Casualty and Surety Company v. Commissioner, 65 T.C. 897, 906 (1976), (. . . "even though the expense was 'shown' on the annual statement, no 'expense incurred' deduction was allowed [for tax purposes] because the item was not deductible under subsection [832](c).")

The taxpayer implicitly accepted this interpretation by not claiming a tax deduction for the unpaid employee expenses allocated to Investment Expense and Other Underwriting Expense, even though such allocations are included as deductions in the annual statement approved by the state insurance commissioner. We believe that the prohibition on the deduction of unpaid employee benefits contained in § 404 forbids their deduction on a tax return despite the Code's reliance on the annual statement for some purposes.

Conclusion

) We conclude that the cost of unpaid employee benefits are not deductible for income tax purposes, regardless of whether they are allocated to loss adjustment expenses and regardless of whether they are deducted in the annual statement.

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